

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Longville Analyst: Roger Lackey Bill Number: AB 2001

Related Bills: None Telephone: 845-3627 Amended Date: 06-29-2000

Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** California Spaceport Development Zone Act of 2000

### SUMMARY OF BILL

Under the Government Code, this bill would require the Trade and Commerce Agency (TCA) to designate, upon application of an eligible city, county, or city and county, spaceport development zones to promote the development of a commercial space transportation system in the state.

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would allow qualified taxpayers in a spaceport development zone to claim a sales or use tax credit, a hiring credit, an employee wage credit, a business expense deduction, and a 100% carry over of their net operating losses (NOLs) for a period of 20 years.

This analysis will address the Government Code provisions of the bill only as they impact the department's programs and operations or state income tax revenue.

### SUMMARY OF AMENDMENT

The June 29, 2000, amendments deleted the prior language of the bill and inserted the language discussed in this analysis.

This is the department's first analysis of the bill.

### EFFECTIVE DATE

This bill would be effective January 1, 2001, and operative for taxable or income years beginning on or after that date.

### PROGRAM HISTORY/BACKGROUND

California has four types of economic development areas that have similar tax incentives:

?? Enterprise Zones,  
?? Local Agency Military Base Recovery Areas (LAMBRA),  
?? Targeted Tax Area (TTA), and  
?? Manufacturing Enhancement Areas (MEA)

#### Board Position:

_____ S	_____ NA	_____ NP
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_____ N	_____ OUA	_____ X PENDING

#### Department Director

#### Date

Gerald H. Goldberg

8/8/00

The following table shows the incentives available to each of the economic development areas.

Types of Incentives	EZ	LAMBRA	TTA	MEA
Sales or Use Tax Credit	X	X	X	
Hiring Credit	X	X	X	X
Employee Wage Credit	X			
Business Expense Deduction	X	X	X	
Net Interest Deduction	X			
Net Operating Loss	X	X	X	

#### SPECIFIC FINDINGS

**Existing federal law** specifies empowerment zones and enterprise communities to provide economic revitalization of distressed urban and rural areas. The Secretary of Housing and Urban Development and the Secretary of Agriculture designated nine empowerment zones and 95 enterprise communities from areas nominated by state and local governments (one enterprise community in Imperial County and one enterprise community in Watsonville). In addition, the Secretary designated two supplemental enterprise zones (one in Los Angeles) and four enhanced enterprise communities (one in Oakland).

Qualified zone businesses operating in federal empowerment zones and enterprise communities are eligible to finance property with exempt facility private activity bonds. This exempt bond is the only tax incentive available to businesses operating in enterprise communities. Two additional tax incentives are available in empowerment zones: (1) qualified empowerment zone businesses are allowed an additional \$20,000 depreciation expense deduction, (2) and employers are entitled to a 20% tax credit for the first \$15,000 of wages paid to certain empowerment zone employees.

State or local governments located in areas in which empowerment zones and enterprise communities are designated are eligible to receive block grants for social services and economic development block grants for use in accordance with the strategic plan submitted by the state or local government in the designation nomination process.

The state or local governments located in areas in which supplemental empowerment zones and enhanced enterprise communities are designated receive economic development grants and social services grants. Businesses that operate in these areas receive no special tax benefits.

**Under the Government Code, existing state law** provides for the designation of enterprise zones, Local Agency Military Base Recovery Areas (LAMBRA), a Targeted Tax Area (TTA), and two Manufacturing Enhancement Areas (MEA). Using specified criteria, TCA designates these economic development areas from the applications received from the local governing bodies. Enterprise zones are designated for 15 years (except enterprise zones meeting certain criteria may be extended to 20 years). Eight LAMBRA designations are authorized, at least one from each of five regions (as specified) of the state. Currently, TCA has designated four of the eight LAMBRAs, and one other area has received conditional designation. Each LAMBRA designation is binding for eight years. The TTA was designated November 1, 1998, and the MEAs were designated October 1, 1998. Both the TTA and MEAs are binding for 15 years beginning January 1, 1998.

**Under the Revenue and Taxation Code, existing state law** provides special tax incentives for taxpayers conducting business activities within economic development areas (such as enterprise zones). These incentives include a sales or use tax credit, hiring credit, business expense deduction, and special NOL treatment. A discussion of each incentive, plus an employee wage credit and net interest deduction discussion, follows.

### **Sales or Use Tax Credit**

The sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified property purchased for exclusive use in an enterprise zone. The amount of the credit is limited to the tax attributable to enterprise zone income. Qualified property is defined as follows:

- ~~///~~ Machinery and machinery parts used for:
  - ~~///~~ manufacturing, processing, assembling, or fabricating;
  - ~~///~~ producing renewable energy resources; or
  - ~~///~~ air or water pollution control mechanisms.
- ~~///~~ Data processing and communication equipment.
- ~~///~~ Certain motion picture manufacturing equipment.

In addition, qualified property must be purchased and placed in service before the enterprise zone designation expires. The maximum cost of property that may be eligible for the enterprise zone sales or use tax credit is \$1 million for individuals and \$20 million for corporations.

### **Hiring Credit**

A business located in an enterprise zone may reduce tax by a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated as an enterprise zone and meet certain other criteria. At least 90% of the qualified employee's work must be directly related to a trade or business located in the enterprise zone and at least 50% must be performed inside the enterprise zone. The business may claim up to 50% of the wages paid to a qualified employee as a credit against tax imposed on enterprise zone income. The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage (under special circumstances for the Long Beach enterprise zone, the maximum is 202% of the minimum wage). The amount of the credit must be reduced by any other federal or state jobs tax credits and the taxpayer's deduction for ordinary and necessary trade or business expenses must be reduced by the amount of the hiring credit.

### **Business Expense Deduction**

A business located in an enterprise zone may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the enterprise zone. The deduction is allowed in the taxable or income year in which the taxpayer places the qualified property in service. The basis of the property must be reduced by the amount of the deduction. The maximum deduction for all qualified property is the lesser of 40% of the cost or the following:

If the property was placed in service:

Months after designation	Maximum deduction
0 to 24	\$40,000
25 to 48	30,000
48 and over	20,000

#### **NOL Deduction**

A business located in an enterprise zone may elect to carry over 100% of the enterprise zone NOLs to deduct from enterprise zone income in future years. The election must be made on the original return for the year of the loss. The NOL carryover is determined by computing the business loss that results from business activity within the enterprise zone.

#### **Employee Wage Credit**

Certain disadvantaged individuals are allowed a credit for wages received from an enterprise zone business. Public employees are not eligible for the credit. The amount of the credit is 5% of "qualified wages," defined as wages subject to federal unemployment insurance. For each dollar of income received by the taxpayer in excess of qualified wages, the credit is reduced by nine cents. The credit is not refundable and cannot be carried forward. The amount of the credit is limited to the amount of tax that would be imposed on income from employment within the enterprise zone, computed as though that income represented the taxpayer's entire taxable income.

#### **Net Interest Deduction**

A deduction from income is allowed to certain lenders for the amount of net interest earned on loans made to a trade or business located within an enterprise zone. Net interest is defined as the gross amount of the interest less any direct expenses (e.g., commissions paid) incurred in making the loan. The loan must be used solely for business activities within the enterprise zone and the lender may not have an equity or other ownership interest in the enterprise zone trade or business.

#### **General Incentive Limitation -- Apportionment of Zone Income**

For businesses operating inside and outside an enterprise zone, the amount of credit or net operating loss deduction that may be claimed is limited by the amount of tax on income attributable to the enterprise zone. Income is first apportioned to California using the same formula as that used by all businesses that operate inside and outside the state (property, payroll, a double-weighted sales factor). This income is further apportioned to the enterprise zone using a two-factor formula based on the property and payroll of the business.

**This bill** would authorize a new type of economic development area called a "spaceport development zone." This bill would specify that TCA shall designate only a city, county, or city and county that meets certain criteria regarding the spaceport development zone. A designation made by TCA would be binding for an undetermined amount of time from the date of the original designation.

**This bill** would provide TCA the authority to audit the program of any jurisdiction in any designated spaceport zone, relating to the goals, objectives, and commitments made by the program at its designation date. The bill would provide specific ratings that would determine if the zone would continue or be dedesignated. As such, the bill also provides TCA the authority to dedesignate a zone.

**Under the PITL, this bill** would provide taxpayers doing business or employed in a spaceport development zone the same tax benefits that are allowed taxpayers doing business or employed in an enterprise zone, as described above. Also, this bill would allow the sales and use tax credit and the hiring credit to reduce regular tax below tentative minimum tax, as is allowed for other economic development area credits.

**Under the B&CTL, this bill** would provide taxpayers doing business or employed in a spaceport development zone the same tax benefits that are allowed taxpayers doing business or employed in an enterprise zone. However, the bill also would provide a net interest deduction to certain lenders similar to that described above and would not allow the sales and use tax and hiring credit to reduce regular tax below tentative minimum tax.

#### Policy Considerations

Federal law prohibits discriminatory state taxation of interest on federal securities. This bill would allow a deduction related to interest received by lenders that borrow money to taxpayers engaged in a trade or business in a spaceport development zone. This incentive, which provides a subsidy to non-federal securities, could be considered to result in a violation of the federal law prohibiting discriminatory state taxation of interest on federal securities.

This bill would establish two inconsistencies based on the type of taxpayer. For example, it would allow a net interest deduction only to taxpayer-lenders that file a corporate return. Also, it would not allow corporate taxpayers to use their sales and use tax or hiring credit to reduce regular tax below tentative minimum tax as individual taxpayers would be allowed to do.

The bill would allow TCA to designate a spaceport development zone. However, the bill does not limit the number of zones TCA may designate or the length of time they would remain designated. Current economic area provisions contain limits on the number of zones or areas that may be designated and specify a time period for when the zone or area will expire.

#### Implementation Considerations

The hiring credit provision of the bill mirrors that of the existing hiring credit for other economic zones; however, the language of the bill does not include the criteria for "disadvantaged and disabled" employees. It is unclear if this was an oversight or it was the author's intent to exclude these criteria.

The hiring credit and the employee wage credit both define the term "qualified employee" for purposes of credit eligibility and exclusion from eligibility. These definitions impose the additional requirement that the employer obtain certification that the employee meets the elements for a "qualified employee." This certification must be obtained from the Employment Development Department, the local county or city Job Training Partnership Act administrative entity, or the local county GAIN office or social service agency, as appropriate. While the bill does not specifically tie the general eligibility requirements to claim these credits to the requirement that certification be obtained, the department has interpreted this phrase in other similar incentive provisions administered by the department to mean that without the certification the credits would be denied. Moreover, under similar incentive provisions administered by the department, taxpayers have been unable to obtain a required certification for reasons not related to eligibility (for example, if the certifying agency is not providing certifications). It is unclear in those circumstances whether the taxpayer is eligible for the credit in the absence of obtaining the certification.

As a result of these implementation concerns, the author may wish to clarify his intent with respect to the certification requirement of each credit. It is suggested that the statute make clear that a taxpayer would not be eligible to claim the hiring credit or the employee wage credit unless the certification is obtained. An exception to this requirement would be where the department finds that the taxpayer was unable to obtain the certification through no fault of their own. For example, the local certifying agency was not issuing any certifications. The department can provide language to clarify the author's intent in this area.

The 40% business expense deduction for qualified property contains a recapture provision. It specifies that the deduction shall be recaptured if the property ceases to be used within the spaceport development zone "at any time before the close of the second taxable [income] year after the property is placed in service." The department would interpret this recapture provision in a manner consistent with the Legislature's original intent for calculating the recapture period for similar incentives. It was the Legislature's intent then to look to the last day of the taxable or income year in which the qualified property was placed in service and then add two more taxable or income years after that date to determine the recapture period. However, the recapture provisions may also be interpreted to require only for two taxable or income years "to close" from the date the item of property is placed in service, which is a shorter recapture period. Under the second interpretation, the first taxable [income] year would be the taxable year the property was placed in service. The author may wish to clarify his intent on this issue to resolve any confusion that may occur between the FTB and taxpayers in regard to the proper interpretation.

Department staff would be available to assist the author in drafting amendments to resolve the implementation considerations.

### Technical Considerations

The business expense deduction provisions (Section 17256.6 and Section 24367) refer to "Section 1245" property and further defines "Section 1245" by reference to a specific paragraph of Section 1245 of the IRC, which may lead to confusion. In addition, the bill contains several erroneous references to the Internal Revenue Code. The attached amendments would clarify this language by duplicating the language used in other zone sections and eliminate the erroneous references.

### FISCAL IMPACT

#### Departmental Costs

This bill would not significantly impact the department's costs.

#### Tax Revenue Estimate

It is not possible to predict in advance the number and location of designated Spaceport Development Zones, the response of potential individuals or business entities in such zones to the proposed tax incentives, or the amount of expenses qualifying for claiming tax benefits in any given year.

The average revenue loss for the existing 38 enterprise zones was approximately \$1 million (per enterprise zone) for 1996. The highly technological nature of the proposed zones would indicate that revenue losses for spaceport zones could far exceed the experience of existing incentive zones.

### BOARD POSITION

Pending.

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Attorney	Patrick Kusiak

FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO AB 2001  
As Amended June 29, 2000

AMENDMENT 1

On page 26, line 14, strikeout "1245" and insert:

17252.6

AMENDMENT 2

On page 26, line 18, strikeout "1245" and insert:

17252.6

AMENDMENT 3

On page 26, line 25, strikeout "1245" and insert:

17252.6

AMENDMENT 4

On page 26, line 35, strikeout "1245" and insert:

17252.6

AMENDMENT 5

On page 28, line 12, strikeout "1245" and insert:

17252.6

AMENDMENT 6

On page 28, line 13, strikeout "1245" and insert:

17252.6

AMENDMENT 7

On page 41, line 34, strikeout "1245" and insert:

24367



AMENDMENT 8

On page 41, line 38, ~~strikeout~~ "1245" and insert:

24367

AMENDMENT 9

On page 42, line 1, ~~strikeout~~ "1245" and insert:

24367

AMENDMENT 10

On page 42, line 11, ~~strikeout~~ "1245" and insert:

24367

AMENDMENT 11

On page 42, line 30, ~~strikeout~~ "of the Internal Revenue Code"

AMENDMENT 12

On page 43, lines 36 and 37, ~~strikeout~~ "of the Internal Revenue Code,"

AMENDMENT 13

On page 43, line 40, ~~strikeout~~ "of the Internal Revenue Code"

AMENDMENT 13

On page 44, line 2, ~~strikeout~~ "1245" and insert:

24367

AMENDMENT 14

On page 44, line 4, ~~strikeout~~ "1245" and insert:

24367